Tulsa Law Review

Volume 24 | Issue 1

Fall 1988

United States Supreme Court Rejects Sweat Equity: Norwest Bank Worthington v. Ahlers

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RECENT DEVELOPMENT

UNITED STATES SUPREME COURT REJECTS "SWEAT EQUITY": *NORWEST BANK WORTHINGTON v. AHLERS*

Patrick W. Fischer*

I. INTRODUCTION

"Financial crisis" and "farming" have become nearly synonymous during the past five years as many farmers have been forced into bankruptcy.[1] The two factors contributing most to the decline in the financial strength of farming were the amount of debt that farmers carried at high interest rates[2] and the sharp decline in farm exports.[3] During the middle and late 1970's, the government encouraged farmers to plant fence-to-fence to feed the world. American farmers exported tons of food daily.[4]

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1. *See generally*, Fischer, *Sweat Equity:* In re Ahlers, 23 TULSA L.J. 37, 37-38 (1987).

2. Heffernan, Agricultural Letter Number 1711, Federal Reserve Bank of Chicago, (July 3, 1987). In the Seventh Federal Reserve District, the number of farmers that had debt on their farms increased from 42% to 63%. This jump occurred particularly from 1974-1979. *Id.* Along with the increase in the number of farmers with debt came a doubling in the amount of debt that the farmers carried. *Id.*

3. *Id.*

4. Brief for Respondents at 11, Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963 (1988) (No. 86-958).

In 1982[5] the bubble burst as exports declined sharply[6] while farm production expenses and interest rates soared higher.[7] The plight of the farmer was similar throughout the country: financial trouble. Many farmers were forced into Chapter 11 bankruptcy reorganization to salvage their farms and their livelihoods. However, further trouble awaited the farmer in bankruptcy because the Bankruptcy Code was not designed to deal with problems unique to farming.

One of those problems was the interpretation of the Absolute Priority Rule, Section 1129(b)(1).[8] This section governs how a reorganization plan should be approved by the debtors and when a court can overrule the debtors' plan. The Supreme Court put this dispute to rest in *Norwest Bank Worthington v. Ahlers*,[9] a farm bankruptcy case in litigation for four years.[10] The Court overruled the Eighth Circuit Court of Appeals decision that allowed the Ahlers to retain an ownership interest in the reorganized farm plan by contributing labor, experience, and expertise.[11] In rejecting the "sweat equity" theory, the Supreme Court also considered for the first time the "no value theory."[12]

II. THE *AHLERS* DECISION

A. *Facts*

James and Mary Ahlers farmed 840 acres near Worthington, Minnesota.[13] During the early 1980's, they expanded their farming operations by purchasing both land and equipment.[14] They financed these acquisitions by using their farmland, crops, livestock, machinery, and

5. During the 1970's, farm land increased in value almost four-fold allowing farmers to borrow more money to expand their operations. This worked fine until 1982 when interest rates were high while farm income dropped dramatically as farm exports decreased. *See* Heffernan, *supra* note 2. *See generally* Wall Street Journal Review and Outlook (Aug. 26, 1985); Brief for the State of Arkansas, Connecticut, Illinois, Iowa, Kentucky, Minnesota, Montana, Nebraska, New York, North Dakota, South Carolina, South Dakota and Texas at 1, Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963 (1988)(No. 86-958).

6. *See* Brief, *supra* note 4 at 10, 11.

7. *See* Heffernan, *supra* note 2. Production expenses were up 54% while interest expenses increased by more than 150% from the 1974 level. *Id.*

8. *See infra* notes 38-41 and accompanying text.

9. 108 S. Ct. 963 (1988).

10. *See* Brief for Petitioner at 3-11, Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963 (1988) (No. 86-958), for a history of the case and how the different courts have decided this case.

11. *In re* Ahlers, 794 F.2d 388 (8th Cir. 1986), *rev'd*, 108 S. Ct. 963 (1988).

12. This argument was initiated in an amicus brief submitted by the Solicitor General.

13. *Ahlers*, 794 F.2d, at 392. The Ahlers owned 560 acres and rented 280 acres of land in Nobles County. *Id.*

14. *Id.*

farm proceeds as collateral.[15] Most of the financing was provided by two major sources.[16] The Federal Land Bank ("FLB") had a first mortgage on the farmland,[17] and Norwest Bank of Worthington ("Norwest") had a second mortgage on the farmland and farm proceeds as well as a first mortgage on almost all of the Ahlers' farm equipment.[18]

In 1983 and 1984, the decline in crop prices and inclement weather caused a drastic decrease in the Ahlers' farm revenues.[19] This decrease in revenues forced the Ahlers to default on their interest payments to Norwest Bank. On November 16, 1984, Norwest initiated a replevin action to gain possession of the collateralized farm equipment.[20] The replevin action was halted two weeks later when the Ahlers obtained an automatic stay[21] by filing a Chapter 11 bankruptcy reorganization petition.[22]

Norwest Bank subsequently filed for relief from the automatic stay and sought adequate protection.[23] The bankruptcy court found Norwest undersecured due to dropping values in farm machinery and land, entitling it to adequate protection compensation.[24] The Ahlers fought this ruling, and numerous motions and proceedings followed.[25] The case finally went to the Eighth Circuit Court of Appeals, which ruled on the compensation issue as well as other bankruptcy issues in the case on July 2, 1986.[26]

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15. Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963 (1988).

16. The Ahlers were indebted to three other creditors for a total amount of $42,028. These debts were secured by a combine ($35,791), storage bin ($3337), and an automobile ($2,900). *Ahlers*, 794 F.2d at 392.

17. The Federal Land Bank was owed $524,854 on four parcels of land. The financing for these acquisitions began in 1965. The last purchase was made in 1982. *Id.*

18. Norwest Bank was owed approximately $450,000 when the original suit was brought. *Id.*

19. There was also a drastic drop in the value of land and farm machinery at this time.

20. The petition was filed in Minnesota State Court under MINN. STAT. ANN. § 565.23 (West Cum. Supp. 1985). In Re *Ahlers*, 794 F.2d at 392-93.

21. *Id.* Section 362 of the Bankruptcy Code governs automatic stays. For a detailed analysis of automatic stays. *See* Kennedy, *Automatic Stays Under the New Bankruptcy Laws*, 1980 ANN. SURV. OF BANKR. L. 23 (1980).

22. *See* 11 U.S.C. § 362(a) (1982 & Supp. 1986). This section explains how a reorganization will occur and the rules governing it.

23. *Ahlers*, 794 F.2d at 393. The Federal Land Bank also joined Norwest in this petition. *Id.*

24. *Id.* The bankruptcy court stated that Norwest was "entitled to compensation as adequate protection for the delay of enforcing contractual repossession and foreclosure rights during the interim between the filing of the petition and confirmation of the plan. It is the present value of that interest, the opportunity lost, that must be protected." *Id.* (citation omitted).

25. *See Ahlers*, 794 F.2d at 393, which discusses most of the legal proceedings in which these two opponents were involved.

26. *Id.* The Eighth Circuit had previously made a decision on the automatic stay and also on the feasibility of a reorganization plan, and sent it back to the State District Court before this appeal was decided. *Id.*

The Eighth Circuit had ruled and remanded the case to the Minnesota district court, but the lower court did not follow the Eighth Circuit's instructions.[27] The court of appeals ruled that Norwest Bank should not be given relief from the automatic stay[28] and that a feasible reorganization plan could be made.[29] There were many issues that the court examined to determine how the automatic stay should be handled,[30] but the final decision was based upon Minnesota laws that governed the case.

The court also held that a feasible reorganization plan could be made for the Ahlers' farm.[31] The court rejected Norwest's and FLB's contention that the Bankruptcy Code's absolute priority rule must be followed. The rule, which was adopted by Section 1129(b)(2)(B),[32] provides that a dissenting class of unsecured creditors must be replenished before any junior class can retain or receive any property under the plan.[33]

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27. *Id.*

28. *See* Fischer, *supra* note 1 at 60-68, for an in-depth and complete discussion of the court's decision and the issues it faced.

29. *See* Comment, *Bankruptcy—Chapter 11 Reorganization—Determining the Starting Date of Adequate Protection Payments for Opportunity Cost and Expanding the Contribution Exception to the Absolute Priority Rule*, 63 N.D.L. REV. 405, 408-09 (1987).

30. *Ahlers*, 794 F.2d at 395-97.

31. *Id.* at 396-97.

32. *Id.* at 401. The Eighth Circuit gives a very detailed analysis on the creation of the absolute priority rule.

33. Section 1129 states in pertinent part:

(b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claims; or

(ii) the holder of any claim or interest that is junior to the claims of such class

However, in *Case v. Los Angeles Lumber Co.*[34] the United States Supreme Court modified the rule to allow a junior creditor to participate in the reorganization plan and receive an equity interest if the junior creditor contributed "money or money's worth" to the reorganization plan.[35] The Eighth Circuit used the "money's worth" language to conclude that the Ahlers' contribution to the plan could be the "labor, experience and expertise" from their work on the farm.[36] These contributions effectuated approval of the plan over the objections of the creditors. The Ahlers' expertise was needed to make the farm profitable. Furthermore, the liquidated value of the assets would be less than the reorganization plan, which kept the farm operating.[37]

B. *Supreme Court Decision*

On appeal from the Eighth Circuit, the Supreme Court delineated proper application of the "absolute priority rule."[38] The Court began its analysis by defining the rule and examining the legislative and case law history. The absolute priority rule "provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property under a reorganization plan."[39] The rule's origin is in the judicial construction of the underlying bankruptcy statute requirement that a plan be "fair and equitable."[40] This judicial rule was finally codified in Section 1129(b)(2)(B)(ii) of the Bankruptcy Code in 1978.[41]

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will not receive or retain under the plan on account of such junior claim or interest any property.

(C) With respect to a class of interests—

(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

11 U.S.C. § 1129(b) (1982 & Supp. 1985). *See Ahlers*, 794 F.2d at 401, for a discussion of the development of 1129(b)(1) and the significance of *Northern Ry. v. Boyd*, 228 U.S. 482 (1913).

34. 308 U.S. 106 (1939). In this case, the old shareholders were allowed to put capital into the reorganization and keep an equity interest in the reorganized business.

35. *Ahlers*, 794 F.2d at 401.

36. Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963, 967 (1988).

37. *Ahlers*, 794 F.2d at 402. *See also* Fischer, *supra* note 1, at 66-67.

38. *See Norwest Bank*, 108 S. Ct. at 966-68.

39. Id. at 966 (quoting *Ahlers* 794 F.2d at 401).

40. *See* Louisville Trust Co. v. Louisville New Albany & Chicago Ry., 174 U.S. 674, 684 (1899).

41. *See also* B. WEINTRAUB & A. RESNICK, BANKRUPTCY LAW MANUAL ¶ 8.03 (1986).

The Supreme Court observed that the statutes do not allow a Chapter 11 reorganization plan to be confirmed over the creditor's legitimate objections,[42] and that the reorganization plan left the Ahlers with an equity interest in their farm that was contrary to the absolute priority rule.[43] The court of appeals did not disagree, but instead had found an exception under *Case v. Los Angeles Lumber Products Co.*: An equity interest can be given if the debtor makes a contribution of "money or money's worth."[44] The Supreme Court disagreed with that court's characterization of the Ahlers' labor, experience, and expertise in running the farm as constituting "money's worth." It would be very difficult to value and measure the Ahlers' contribution in order to fit into the *Los Angeles Lumber* exception.[45]

Next, the Court considered the Congressional history behind the adoption of the absolute priority rule. In the *Los Angeles Lumber* case, existing shareholders pledged " 'their financial standing and influence in the community' and their 'continuity of management' to the reorganized enterprise."[46] The Court found that this was not "money's worth" but merely vague hopes or possibilities. A balance sheet does not provide for this type of contribution, and the Ahlers' promise of service to the farm would be unenforceable if they decided not to perform their services on the farm.[47] To be the equivalent of money's worth, the contribution must be of value to the creditors today, not some hope of possible service or value in the future.[48] The Supreme Court compared the promises made by the Ahlers with those made in *Los Angeles Lumber* and concluded that neither were tantamount to "money's worth." This type of

42. *See* 11 U.S.C. § 1129(b)(2)(B)-(C) (1982 & Supp. IV 1986).

43. *Norwest Bank*, 108 S. Ct. at 966.

44. *Id.*

45. The Eighth Circuit Court of Appeals never stated how the value of a farmer's labor, experience, and expertise should be measured but only that it would be easy to make this determination. *In re* Ahlers, 794 F.2d, 388, 402 (8th Cir. 1986). The Supreme Court described the impact of this decision on the *Los Angeles Lumber* case:

> Thus, our decision today should not be taken as any comment on the continuing vitality of the *Los Angeles Lumber* exception—a question which has divided the lower courts since passage of the Code in 1978. Compare, *e.g., In re Sawmill Hydraulics, Inc.*, 72 B.R. 454, 456, and n. 1 (Bkrtcy. Ct. CD Ill. 1987) with, *e.g., In re Pine Lake Village Apartment Co.*, 19 B.R. 819, 833 (Bkrtcy. Ct. SDNY 1982). Rather, we simply conclude that even if an "infusion-of-'money-or money's-worth' " exception to the absolute priority rule has survived the enactment of § 1129(b), respondents' proposed contribution to the reorganization plan is inadequate to gain the benefit of this exception.

Norwest Bank, 108 S. Ct. at 967 n.3.

46. *Id.* at 967.

47. *Id.* No other court of appeals decision has allowed labor, experience, and expertise to fit into the *Los Angeles Lumber* exception. *Id.*

48. *Id.* at 967-68.

contribution was not intended "to escape the absolute priority rule."[49]

The Court then looked at the legislative history behind the absolute priority rule to determine if the Ahlers' management contribution fit into a proposed broader exception of the Bankruptcy Code. The Bankruptcy Commission submitted a proposal to modify the absolute priority rule and thus permit equity-holders to participate in a reorganized enterprise based on a contribution of " 'continued management . . . essential to the business' or other participation beyond 'money or money's worth.' "[50] Congress rejected this view and instead adopted the current Section 1129(b)(2)(B). The Supreme Court considered Congress' rejection of the view that there was no general exception to the absolute priority rule, thus there was no congressional basis for the Ahlers' suggestion.[51]

The second argument advanced by the respondent was equitable in nature. Since the nature of a bankruptcy proceeding is in equity, the Ahlers proposed that it was inequitable for the class of unsecured creditors to reject the reorganization plan.[52] The Supreme Court rejected this argument, stating that even though a bankruptcy court has equitable powers, its rulings can be made only within the "confines" of the Bankruptcy Code.[53] The Code requires the bankruptcy plan to be fair and equitable, and it allows creditors an opportunity to vote on the plan and withhold approval if it does not protect them adequately.[54] Although creditors might be better off by approving the plan, courts are not entitled to make such decisions.

The third theory advanced by Ahlers provided that the absolute priority rule was inapposite. The basis advanced for inapplicability was that the Ahlers sought to retain a property interest with no value to the senior unsecured creditors, and therefore of no concern to those creditors.[55] The Ahlers argued that the "farm has no 'going concern' value (apart from their own labor on it), any equity interest they retain in a reorgnization of the farm is worthless, and therefore is *not 'property'* under 11 U.S.C. § 1129(b)(2)(B)(ii) . . . ."[56]

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49. *Id.* at 968.

50. *Id.* This proposal received considerable criticism. *See* Brudney, *The Bankruptcy Commission's Proposed 'Modifications' of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305 (1974).

51. Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963, 968 (1988).

52. *Id.* In order for a plan to be fair and equitable, it must take into consideration the best interests of all parties involved. *Id.*

53. *Id.* at 968-69.

54. *Id.* at 969. The Code gives approval authority to the creditors, not the courts. *Id.*

55. *Id.*

56. *Id.* (emphasis added).

This argument is called the "no value" theory and has been overwhelmingly rejected by a majority of jurisdictions as well as the Supreme Court.[57] The term "property" has been given a broad definition by both case law and legislative history. Even when debts exceed the current value of assets, a debtor who receives an equity interest in the business has received or retained a property interest.[58] After first determining that the definition of property would include the Ahlers' interest, the Court concluded that the "no value theory" was inappropriate in this case.[59] The Ahlers' interest was property under Section 1129(b)(2)(B)(ii) and could be retained only if the reorganization plan were accepted by the creditors "or formulated in compliance with the absolute priority rule."[60]

In conclusion, the Court acknowledged the seriousness of the farm situation but declined to address the problem. Because Congress has tried to respond to the difficulties farmers face in reorganizing the debt on their farms with the recent enactment of Chapter 12, the Court would not interfere.[61]

III. ANALYSIS

The Court's decision on the absolute priority rule and the *Los Angeles Lumber* case were the only logical conclusions that it could reach. The Eighth Circuit Court of Appeals never argued that the Ahlers could escape the absolute priority rule; instead, it maintained that *Los Angeles Lumber* created an exception to the rule.[62] This analysis is clearly erroneous. The *Los Angeles Lumber* decision provided:

> [T]hey [management skills, financial standing and influence in the community] cannot possibly be translated into money's worth reasonably equivalent to the participation accorded the old stockholders. They have no place in the asset column of the balance sheet of the new company. They reflect merely vague hopes or possibilities. As such,

57. *Id.* Apparently, only one case has accepted this theory in a case similar to this one. *See In re* Star City Rebuilders, Inc., 62 Bankr. 983, 988-89 (Bankr. W.D. Va. 1986). Cases rejecting the theory are: *In re* Modern Glass Specialists, Inc., 42 Bankr. 139 (Bankr. E.D. Wis. 1984); *In re* Huckabee Auto Co., 33 Bankr. 132 (Bankr. M.D. Ga. 1981); *In re* Landau Boat Co., 8 Bankr. 436 (Bankr. W.D. Mo. 1981). *Id.* at 969 n.6.

58. Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963, 969 (1988). It does not matter whether the value is present or prospective. For purposes of control or to receive dividends, it is still property. *Id.*

59. *Id.* at 970. The Eighth Circuit stated the Ahlers would be able to share in the profits. If that is the case, then there certainly is value and, therefore, a property interest. *Id.*

60. *Id.*

61. *Id.* at 970-71.

62. *See supra* note 45 and accompanying text.

> they cannot be the basis for issuance of stock to otherwise valueless interests.[63]

While the argument could be made that the Ahlers' contribution of labor, experience, and expertise could be ascertained more easily than the contributions offered by the debtors in *Los Angeles Lumber*, it is still inadequate for purposes of the "money's worth" exception. Further, the senior creditors could not sell the Ahlers' contribution or force them to continue to work the farm. Thus, the Ahlers' contribution is "intangible, inalienable, and, in all likelihood, unenforceable."[64]

The Ahlers attempted to argue their case around the "money's worth" dicta, which required a tangible asset of a defined value to be contributed in order to get an equity position in the reorganized business. The Court seems to have required that the debtor offer a cash substitute and summarized, "There is no way to distinguish between the promises [the Ahlers] proffer[ed] here and those of the shareholders in *Los Angeles Lumber*; neither is an adequate contribution to escape the absolute priority rule."[65]

The Ahlers also argued that there is an overall broad exception to the absolute priority rule. However, the legislative history does not support such an argument. There was a proposal before Congress to allow former equity holders or shareholders to participate in the reorganized business for their management and labor skills to be codified in the Code, but this met with such opposition that it was rejected.[66] Since the proposal was rejected, it was illogical to argue that a broader exception existed beyond this argument or the *Los Angeles Lumber* case.

Finally, the "no value" argument has no place in this case. Apparently, only one court[67] has accepted the theory, while the majority has

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63. Case v. Los Angeles Lumber Co., 308 U.S. 106, 122-23 (1939) (footnote omitted).

64. *Norwest Bank*, 108 S. Ct. at 967.

65. *Id.* at 967-68.

66. Brief for Petitioners at 16-17, Norwest Bank Worthington v. Ahlers, 108 S. Ct. 963 (1988)(No 86-958). The petitioners maintained that

> [o]ne of the Bankruptcy Commission's proposals to Congress was to modify the Absolute Priority Rule and reject *Los Angeles Lumber*. *See Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. 254-259 (1973). The Bankruptcy Commission endorsed participation in the reorganized debtor by former shareholders or equity interest holders in exchange for their management skill and labor. *Id.* at 258-59. After extensive hearings and debate, the proposed modification was rejected by Congress and the Absolute Priority Rule was codified at Section 1129(b)(2). The legislative history makes it clear that to confirm a plan over the dissent of a class of unsecured claims, "they must be paid in full or, if paid less than in full, then no class junior may receive anything under the plan. . . ."

Id. (footnote omitted).

67. *See In re* Star City Rebuilders, Inc., 62 Bankr. 983 (Bankr. W.D. Va. 1986).

rejected the theory that the equity interest is not a "property" interest.[68] If the Ahlers were allowed to retain an interest, that interest should surely be construed as property under section 1129(b). While the Code itself does not define property, the legislative history gives the word a broad meaning: " '[P]roperty' includes both tangible and intangible property."[69] The Ahlers would receive an interest in a reorganized business that could yield them a profit if the property were sold for a price above that which is owed the creditors. This may be a speculative future gain, yet it represents the possibility of profit and thus a "property" interest. The Court correctly observed that if there is no property or value at stake, then there would have been no motivation for over three years of litigation.[70]

IV. CONCLUSION

The Supreme Court finally put to rest the novel idea that experience, expertise, and labor could be used to allow the debtor to acquire an equity interest in the reorganized business. The Supreme Court seemed to be saying that the Code stands as is, and that any changes will have to be made by Congress. Had the Supreme Court affirmed the *Ahlers* case, it would have made a Chapter 11 bankruptcy reorganization much more attractive for farmers than the recently enacted Chapter 12. The result, however, would have been aid to farmers beyond Congress' intention.

68. *See supra* note 57.
69. *Norwest Bank*, 108 S. Ct. at 969 (citation omitted).
70. *Id.* at 970.